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LAW OFFICES

JENNER & BLOCK, LLC

601 THIRTEENTH STREET, N.W.
SUITE 1200 SOUTH
WASHINGTON, D.C. 20005

FIRM: (202) 639-6000
FAX: (202) 639-6066

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

MARK D. SCHNEIDER

DIRECT DIAL: 202-639-6005
INTERNET ADDRESS: jkelley@jenner.com

August 27, 2001

Magalie R. Salas, Esq.
Federal Communications Commission
Office of the Secretary
The Portals
445 12th St. S.W.
Room TWB 204
Washington, D.C. 20554

Re: CC Docket Nos. 00-218, 00-249, and 00-251

Dear Ms. Salas:

Enclosed for filing please find an original and three copies of WorldCom, Inc. and AT&T's Rebuttal Testimony, including a CD ROM containing supporting work papers, on pricing issues. An additional eight copies have been provided in a separate envelope to be delivered to the arbitrator. Finally, an extra copy is enclosed to be file-stamped and returned.

If you have any questions, please do not hesitate to call me at 202-639-6005. Thank you very much for your assistance with this matter.

Very truly yours,

Mark D. Schneider

Mark D. Schneider

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CERTIFICATE OF SERVICE

I do hereby certify that true and accurate copies of the foregoing AT&T and WorldCom's Rebuttal Testimony on pricing issues were delivered this 27th day of August, 2001, by federal express and regular mail to:

Karen Zacharia
David Hall
Verizon-Virginia, Inc.
1320 North Courthouse Road, 8th Floor
Arlington, VA 22201
** By Federal Express*

Richard D. Gary
Kelly L. Faglioni
Hunton & Williams
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
** By Federal Express*

Catherine Kane Ronis
Wilmer, Cutler & Pickering, LLP
2445 M Street, NW
Washington, DC 20037-1420
**By Federal Express*

Lydia Pulley
600 East Main Street
11th Floor
Richmond, VA 23219
** By Federal Express*

J.G. Harrington
Dow, Lohnes & Albertson
1200 New Hampshire Ave., N.W., Suite 800
Washington, D.C. 20036
* *By Regular Mail*

By: ______________________
Mark D. Schneider

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AUG 27 2001

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of
Petition of AT&T Communications of Virginia, Inc., Pursuant to Section 252(e)(5) of the Communications Act, for Preemption of the Jurisdiction of the Virginia State Cooperation Commission Regarding Interconnection Disputes with Verizon-Virginia, Inc.

ORIGINAL

In the Matter of
Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Expedited Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon-Virginia, Inc., and for Expedited Arbitration

CC Docket No. 00-218

REBUTTAL TESTIMONY OF JOHN I. HIRSHLEIFER

ON BEHALF OF

AT&T[1] AND WORLDCOM, INC.

August 27, 2001

[1] The AT&T entities sponsoring this Rebuttal Testimony are AT&T Communications of Virginia, Inc., TCG Virginia, Inc., ACC National Telecom Corp., MediaOne of Virginia and MediaOne Telecommunications of Virginia, Inc. (together, "AT&T").

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I. <u>INTRODUCTION</u>

Q. PLEASE STATE YOUR FULL NAME AND OCCUPATION.

A. My name is John I. Hirshleifer and my business address is Charles River Associates, Inc., 10877 Wilshire Blvd. Suite #710, Los Angeles, California 90024. I am a Vice President at Charles River Associates, Inc. (CRA), an international financial and economic consulting firm.

Q. ARE YOU THE SAME JOHN HIRSHLEIFER WHO PREVIOUSLY SUBMITTED PREPARED DIRECT TESTIMONY ON BEHALF OF AT&T AND MCI WORLDCOM IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to the prepared direct testimony submitted in this proceeding by Dr. James H. Vander Weide on behalf of Verizon Virginia ("VZ-VA") regarding the cost of capital.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony is organized as follows. In Section II, I address the positions regarding cost of capital advanced by VZ-VA and me. In the remaining sections of the testimony, I address in more detail the analysis submitted by Dr. Vander Weide on behalf of VZ-VA, including his cost of equity estimate (Section III), his estimated cost of debt (Section IV), and his recommended capital structure (Section V).

II. TELRIC COST PRINCIPLES DO NOT REQUIRE THE ASSUMPTION THAT VZ-VA FACES INTENSE COMPETITION REGARDLESS OF THE FACTS.

Q. DR. VANDER WEIDE INDICATES IN HIS DIRECT TESTIMONY THAT THE COST OF CAPITAL IS FORWARD-LOOKING. HE STATES FURTHER THAT "THE FORWARD-LOOKING ECONOMIC COST PRINCIPLE...IS BASED ON THE ASSUMPTION THAT THE MARKET FOR LOCAL EXCHANGE SERVICES IS FULLY COMPETITIVE" [VW, PG. 36]. DOES THE FCC AGREE WITH DR. VANDER WEIDE'S ASSUMPTION?

A. No. In its August 8, 1996 Order, the FCC states explicitly at paragraph 702 that:

> Based on the current record, we conclude that the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and *incumbent LECs bear the burden of demonstrating with specificity* that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital or depreciation rate. *These elements generally are bottleneck, monopoly services that do not now face significant competition.* We recognize that incumbent LECs are likely to face increased risks given the overall increases in competition in this industry, which generally *might* warrant an increased cost of capital, *but note that, earlier this year, we instituted a preliminary inquiry as to whether the currently authorized federal 11.25 percent rate of return is too high given the current marketplace cost of equity and debt.* On the basis of the current record, we decline to engage in a time-consuming examination to determine a new rate of return, which may well require a detailed proceeding. *States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted*, without that commission conducting a 'rate-of-return or other rate based proceeding.' *We note that the risk-adjusted cost of capital need not be uniform for all elements. We intend to re-examine the issue of the appropriate risk-adjusted cost of capital on an*

> *ongoing basis*, particularly in light of the state commissions' experiences in addressing this issue in specific situations. [emphasis added] [footnotes omitted].

It is clear that <u>none</u> of the above provisions stated in paragraph 702 which I have highlighted would be necessary if the FCC intended a presumption of full competition.

Q. IF THE ILEC'S HAVE A STRICT BURDEN OF PROOF REQUIREMENT (AS STATED IN PARAGRAPH 702) FOR DEMONSTRATING THAT THE MARKET FOR NETWORK ELEMENTS IS RISKIER FOR PURPOSES OF COST OF CAPITAL ESTIMATION, CAN DR. VANDER WEIDE MERELY ASSUME THAT THE NETWORK ELEMENT MARKET – WHICH IS AT THIS TIME DOMINATED BY VZ-VA – IS COMPETITIVE?

A. No, he cannot. Dr. Vander Weide has "assumed away" the requisite burden of proof. As Dr. Vander Weide provides no evidence that the business of network element leasing has become fully competitive, this inappropriate foundational assumption appears to make his entire analysis moot.

Q. DOES DR. VANDER WEIDE CITE THE FCC'S MASS. 271 ORDER IN AN ATTEMPT TO BOLSTER HIS FAULTY ASSUMPTION OF A FULLY COMPETITIVE MARKET [VW, P. 6]?

A. Yes. What Dr. Vander Weide fails to note, however, is that the FCC specifically questioned the cost of capital decided by the Massachusetts Department of Telecommunications and Energy in its most recent UNE order because of state specific factors in Massachusetts, such as the level of competition:

> Commenters have raised legitimate concerns regarding some of the inputs used by Massachusetts in calculating its loop rates. In particular, we note that the Massachusetts Department utilized a cost of capital of 12.16 percent. This is higher than the cost of capital that the Massachusetts Department has used in setting Verizon's local rates and substantially higher than the cost of capital employed by any of the other states in Verizon's region. AT&T questions whether there is any reason to believe that offering UNEs on a wholesale basis, where Verizon faces no competition, is riskier than offering retail service, where it now has competition. *We question whether this relatively high cost of capital is sufficiently justified by state-specific factors.*[1] [*emphasis added*] [footnotes omitted]

It is clear that the FCC is not making the hypothetical assumption of full competition that Dr. Vander Weide would attribute to it.

Q. DID THE FCC IN FACT CONSIDER AND EXPLICITLY REJECT THE ASSUMPTION OF FULL COMPETITION FOR TELRIC PURPOSES?

A. Yes. At paragraph 688 of the FCC's August 8, 1996 Order, it stated that "...USTA's argument unrealistically assumes that competitive entry would be instantaneous. The more reasonable assumption of entry occurring over time will reduce the costs associated with sunk investment."

Q. IS THERE ANY CONNECTION BETWEEN DR. VANDER WEIDE'S HYPOTHETICAL ASSUMPTION OF A FULLY COMPETITIVE MARKET AND A FORWARD-LOOKING COST OF CAPITAL?

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1 FCC Memorandum Opinion and Order, *In the Matter of Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., For Authorization to Provide In-Region, InterLATA Services in Massachusetts*, CC Docket No. 01-9, Adopted and released: April 16, 2001, ¶ 38, at 19-20 (footnotes omitted) (emphasis added).

A. None at all. Economic costs of capital are by definition forward looking. In other words, when assessing the cost of capital of any publicly-traded company as of today, the market accounts for all known risks existing currently and the possibility of risks that could develop or increase in the future. In the context of a publicly-traded telephone holding company, which owns local exchange companies and network elements, the market does not hypothetically assume that the network element leasing business will immediately become competitive when the real-world evidence indicates that facilities competition exists only to a very limited degree and may take years to develop. Instead, the market continuously evaluates real-world information regarding all relevant risks, including those which may arise or increase in the future, and incorporates the likelihood of those risks occurring into the current costs of capital of the telephone holding companies. Consequently, by assuming a fully competitive market, Dr. Vander Weide has calculated a purely hypothetical cost of capital, not a forward-looking economic cost of capital as required for this proceeding.

III. THE RATE OF RETURN ADVOCATED BY VZ-VA IS SIGNIFICANTLY HIGHER THAN JUSTIFIED BY THE RISKS OF THE BUSINESS AT ISSUE.

Q. WHAT IS YOUR VIEW OF THE RATES OF RETURN SUBMITTED IN THIS PROCEEDING ON BEHALF OF VZ-VA?

A. I have reviewed the testimony submitted by Dr. James Vander Weide for VZ-VA, who advocates a 12.95 percent return on total capital. I believe this rate of return is excessive, unreasonable, and anticompetitive. Indeed, if the objective of this proceeding is to facilitate competitive access into the local exchange market now served by the LECs – as the FCC's August 8, 1996 Order makes clear – then the rates of return advocated by VZ-VA represent an obstacle to such entry.

Q. WHAT IS THE BASIS FOR YOUR OPINION?

A. Dr. Vander Weide's recommendation is not supported by rigorous analysis that would achieve the objectives of cost of capital estimation.

Q. WHAT ARE THE OBJECTIVES THAT MUST BE SATISFIED IN ESTIMATING THE COST OF CAPITAL FOR PURPOSES OF THIS PROCEEDING?

A. A fundamental objective in estimating the cost of capital is choosing the correct target. The most widely-accepted techniques for determining the cost of capital therefore begin with the capital costs experienced by companies with businesses comparable to the line of business under consideration. In this case, therefore, the first step is to identify a group of comparable companies (or proxy group) with characteristics as similar as possible to the wholesale business of leasing unbundled network elements, which is the business for which the cost of capital is being determined.

Q. WHAT THEN, IS THE CORRECT APPROACH TO ESTIMATING THE COST OF CAPITAL THAT ACHIEVES THIS OBJECTIVE?

A. The correct approach is spelled out in detail in my prepared direct testimony. First, I selected a group of comparable, publicly traded, independent telephone companies from which to derive my data.[2] Second, I calculated the actual debt costs incurred by Verizon. Third, to estimate the cost of equity, I used both: (a) a three-stage discounted cash flow ("DCF") methodology based on the future dividends expected by investors in the comparable group of companies identified in step one; and (b) the capital asset pricing model ("CAPM") in which I calculated a "risk premium" for the comparable companies (based on their price volatility in relation to other stocks), which I then added to a risk free rate of return. Finally, using the debt cost calculated above, and the midpoint of the cost of equity calculated using the DCF and CAPM methods, I calculated a weighted average cost of capital based, alternatively, on Verizon's book capital structure and then on its market weighted capital structure (reflecting the market value of Verizon's stock).

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[2] Currently, there are no "pure-play" companies operating exclusively as a wholesale provider of unbundled network elements. Indeed, there are few, if any, publicly-traded firms that provide only local telephone service. The most comparable companies are the large regional telephone holding companies ("RHC"s), which have been required to provide unbundled network elements at wholesale. If anything, because RHC's currently engage in more risky businesses of selling retail phone service, cellular service, paging, information services, long-distance, cable and the like, using these companies as comparables leads to cost of capital estimates that are necessarily conservative (*i.e.,* too high).

Based on this analysis, I calculated a weighted average cost of capital range of between 9.17 percent and 9.91 percent with the midpoint estimate of 9.54 percent, based on costs of debt and equity of 7.86 percent and 10.42 percent, respectively, and a debt/equity capital structure of 49/51 percent, on the low end, and 20/80, on the high end.

Q. IS DR. VANDER WEIDE'S TESTIMONY CONSISTENT WITH THE MOST FUNDAMENTAL OBJECTIVES OF COST OF CAPITAL ANALYSIS?

A. No, in at least three significant respects. First, in attempting to estimate the cost of equity, Dr. Vander Weide: (a) employs unreasonable sustained growth assumptions in his single stage DCF analysis; and (b) measures the cost of capital for virtually all the S&P Industrials rather than comparable companies in a similar line of business, much less a business established for the purpose of leasing unbundled network elements at wholesale. Second, in measuring the cost of debt, Dr. Vander Weide ignores the debt costs actually incurred in the line of business at issue, using instead the cost of debt reported by Moody's for long term A-rated industrial bonds. Finally, in calculating a weighted average cost of capital, Dr. Vander Weide relies exclusively on a market weighted capital structure for the S&P Industrial and telecommunications companies, notwithstanding that the business of unbundled network elements at wholesale is subject to far fewer risks (competitive and otherwise).

Based on this analysis, Dr. Vander Weide estimates a weighted average cost of capital of 12.95 percent, using a 7.55 percent cost of debt, a 14.75 percent cost of equity, and a debt/equity capital structure of 25/75 percent.

A. DR. VANDER WEIDE'S METHODOLOGY FOR DEFINING THE COST OF EQUITY IS SYSTEMATICALLY BIASED TO PRODUCE AN UNREASONABLY HIGH COST OF CAPITAL ESTIMATE.

Q. WHAT ARE THE MAJOR DEFICIENCIES OF DR. VANDER WEIDE'S APPROACH TO ESTIMATING THE COST OF EQUITY CAPITAL?

A. Almost every aspect of Dr. Vander Weide's approach is indefensible. First, and most significant in terms of his results, Dr. Vander Weide uses a single-stage DCF analysis that assumes that the five year growth rates he observes in his group of "comparable" companies – *i.e.,* the S&P Industrials – will persist indefinitely for the wholesale unbundled network element business at issue in this proceeding.

Second, and more fundamentally, while Dr. Vander Weide agrees with me that the cost of equity capital is largely a function of risk, he does not select a comparable group consisting of companies with similar risk. Instead he performs his primary DCF analysis on a group consisting of virtually all the S&P Industrials, including such diverse firms as autoparts manufacturers, oil companies, producers of food and food ingredients, publishing and entertainment companies and pharmaceutical giants.

Dr. Vander Weide attempts to bootstrap his choice of such an unorthodox (indeed, non-comparable) proxy group, by claiming that there are great risks posed to VZ-VA by facilities-based competition in the Virginia market and by touting the riskiness of the retail telephone business in the local exchange market. However, Dr. Vander Weide ignores the critical facts that VZ-VA is overwhelmingly dominant in its territory, and that the business at hand in this proceeding is not local retail phone service, but rather the wholesale business of leasing network elements to CLECs that provide competitive phone service to an existing retail market.

Third, Dr. Vander Weide misinterprets the TELRIC standard as assuming not only the costs but also the *competitive risks* of a hypothetical highly competitive market. This assumption is not only completely inconsistent with the FCC's August 8, 1996 Order, but also inconsistent with the economic cost of capital.

1) DR. VANDER WEIDE'S PERPETUAL GROWTH ASSUMPTION IS NOT SUBSTANTIATED AND GUARANTEES AN UNDULY HIGH RATE OF RETURN.

Q. WHAT ARE THE CONSEQUENCES OF DR. VANDER WEIDE'S PERPETUAL GROWTH ASSUMPTION?

A. Dr. Vander Weide's approach systematically guarantees an inappropriately high rate of return estimate. Dr. Vander Weide assumes that the I/B/E/S five-year growth rate forecasts for the S&P Industrial companies he uses in his DCF analysis – which on their face make no prediction of growth beyond five years – will continue into the future forever. This has the effect of grossly overstating the return on equity for these companies.

The fallacy of Dr. Vander Weide's growth assumptions is easily demonstrated. If any one of the companies in Dr. Vander Weide's S&P group experienced super-normal growth in excess of the market-wide rate of growth forever, that one company would eventually grow to become the entire economy. The impossibility of such a result proves that rapidly growing companies can continue such growth on average only for a relatively short period of time, at which point their growth must converge with the growth rate of the overall economy. Accounting for the inevitable growth rate convergence in the DCF model – as I did with my three-stage DCF analysis – properly reconciles the cost of equity estimate with market growth assumptions.

Q. IN REBUTTALS TO YOUR TESTIMONIES FILED IN OTHER STATE UNE COST PROCEEDINGS, DR. VANDER WEIDE HAS SAID THAT THE USE OF MULTIPLE STAGE DCF MODELS IS NOT NECESSARY. IS THIS TRUE?

A. No. Quite to the contrary. The perpetual growth assumption systematically guarantees an inaccurately high cost of equity estimate inconsistent with investor expectations. Prominent economists familiar with current cost of capital research have recognized that the simple perpetual growth DCF model using short-run forecasts is inappropriate to use if a company's short-run growth rate is expected to exceed the long-run growth rate of the economy, or the cost of equity will be overestimated. I have cited these economists and practitioners extensively in my direct testimony.

Dr. Vander Weide has cited no credible support for the naïve application of the perpetual growth DCF model using short-run growth forecasts in this circumstance.

Q. DO YOU BELIEVE THAT THIS COMMISSION SHOULD NECESSARILY USE THE PERPETUAL GROWTH DCF MODEL IF IT HAS BEEN USED FROM TIME-TO-TIME IN PAST REGULATORY PROCEEDINGS?

A. No. As highlighted by the excerpts of academics and practitioners cited in my direct testimony, one must understand when the perpetual growth DCF model is – and is not – suitable. In the case of a regulated utility in the traditional regulation setting, growth has traditionally been limited and has not exceeded the growth rate of the economy. If the growth rate does not exceed the economy-wide growth rate, and the growth rate is expected to be very stable, the use of the perpetual growth model is reasonable. In this case, however, I use a set of comparables comprised of holding companies which are engaged in numerous businesses that are, in the short-run, expected to grow at rates much greater than the aggregate economy. Verizon's own international business segment, as an example, grew by 18.6% in 2000 and 21.2% in 1999.[3] It is absolutely clear that this business will not grow at such a high rate indefinitely.

Q. IN PRIOR STATE REBUTTAL TESTIMONIES, DR. VANDER WEIDE HAS ARGUED THAT SOME COMPANIES HAVE GROWN AT HIGH RATES FOR LONGER THAN FIVE YEARS. DOES THIS INVALIDATE YOUR APPROACH AND MAKE THE PERPETUAL GROWTH MODEL MORE SUITABLE?

A. Not at all. In the real world, individual companies participating in a particular line of business will have differing growth rates which will occur over different time periods.

Clearly, a few companies will do extraordinarily well, and may grow at high rates for many years. In fact, in my analysis I assume above average growth for most telephone companies over the next nineteen years. Other companies will perform very poorly, and may experience low or negative growth (or go out of business entirely). Most industry participants will experience growth somewhere between the highest-growth stars and the weak underperformers. Investors today cannot definitively predict which companies in an industry will be the winners and which will be the losers. On average, no reasonable analyst would expect high growth in excess of the economy's growth for all of the industry's companies forever.

Q. DR. VANDER WEIDE HAS ARGUED PREVIOUSLY IN OTHER PROCEEDINGS THAT THE PERPETUAL GROWTH ASSUMPTION IS INCONSEQUENTIAL BECAUSE LATER CASH FLOWS HAVE LITTLE IMPACT ON PRESENT VALUE. IS THIS CORRECT?

A. This is plainly wrong, as evidenced by the enormous difference between Dr. Vander Weide's and my cost of equity estimates using the DCF model. His argument overlooks the tremendous impact of compounding over time. By assuming perpetual dividend growth compounding at unrealistically high rates, but at the same time holding the price of the subject company's stock constant in the DCF model, the discount rate – or cost of equity – must get much higher by mathematical necessity in order to equate the enormous assumed dividends over time to the current price. In contrast, a more logical alternative

[3] Verizon Communications Inc. SEC Form 10-K405 for the period ending 12/31/00.

assumption would be that – if the market genuinely believed that high growth would be realized forever – the price of the subject company would rise.

Q. HOW HAS DR. VANDER WEIDE ATTEMPTED TO DEMONSTRATE THIS ARGUMENT?

A. In a Virginia UNE cost proceeding Dr. Vander Weide attempted to demonstrate the supposed minimal impact of later dividend payments by showing how small a current dividend payment would be when discounted back in time over 20 years. This explanation is inaccurate, however, because in his DCF model future dividends were not fixed at the current dividend value but were growing at his high growth rate for all eternity. It is these inflated dividends that must be discounted when considering the effect of using a single stage model. So, for example, the year 20 dividend is determined by compounding today's dividend for 20 years of growth $[D_0 \times (1 + g_1) \times (1 + g_2) \times \ldots \times (1 + g_{20})]$. This means that dividend payments beyond 20 years are even greater and have a significant effect on the cost of equity derived from a one-stage DCF model when growth rates are higher than the expected growth in the economy.

Q. CAN YOU ILLUSTRATE THE EFFECT OF THIS ASSUMPTION?

A. As an example, I ran my DCF model for Verizon as of June 30, 2000 using a perpetual growth assumption and holding all other factors equal. The cost of equity capital for Verizon derived from this one-stage DCF model is 14.78%. This is 371 basis points higher than the 11.07% cost of equity capital derived from my three-stage model (before ¼-¾ weighting). In order to justify this enormous increase in the cost of equity, proponents of the single-stage model must perform an impossible feat – i.e., present compelling evidence that sample companies will maintain growth rates higher than that of the economy not only for 20 years, but forever, and that the companies' stock prices will not rise to try to capture the enormous value of this phenomenal growth.

2) DR.VANDER WEIDE FAILS TO SELECT A REASONABLE GROUP OF COMPARABLE COMPANIES IN HIS ANALYSIS.

Q. WHY ARE YOU CRITICAL OF DR. VANDER WEIDE'S USE OF THE S&P INDUSTRIALS AS A COMPARISON GROUP FOR ESTIMATING THE COST OF CAPITAL FOR THE WHOLESALE BUSINESS OF LEASING UNBUNDLED NETWORK ELEMENTS?

A. Dr. Vander Weide's primary analysis is based on the performance of large industrial companies generally, rather than a group of comparable companies. As a result, his findings are based on determinants that are irrelevant to the wholesale telephone business. It simply makes no sense to select a proxy group that has nothing in common with firms providing local retail phone service, much less a company set up solely for the purpose of leasing unbundled network elements at wholesale. Under his approach, Dr. Vander Weide must strain to identify similarities among a diverse group of companies – *i.e.,* between companies in the telephone business and large businesses in general – out of a sea of differences.

It makes far more sense to begin with a group of companies – *i.e.,* retail telephone holding companies – that have some similarity to the firm that will sell unbundled network elements at wholesale. At that point, we can discuss intelligently any differences in risk between a company that sells unbundled network elements and one that provides local telephone service at retail.

Q. IS THE USE OF A LARGE, DIVERSE PROXY GROUP LIKE THE S&P INDUSTRIALS TO ESTIMATE COST OF CAPITAL CONSISTENT WITH REAL-WORLD FINANCIAL PRACTICE?

A. No. A fundamental objective in estimating the cost of capital is choosing the correct target. The most widely-accepted technique for determining the cost of capital therefore begins with the capital costs experienced by companies with businesses comparable to the line of business under consideration. In this case, therefore, the first step is to identify a group of comparable companies (or proxy group) with characteristics as similar as possible to the wholesale business of providing network elements, which is the business for which the cost of capital is being determined.

Q. DO INVESTMENT BANKS USE THE S&P INDUSTRIALS AS THE COMPARABLES FOR TELEPHONE COMPANIES?

A. No. Major brokerage firms and investment banks that issue analyst reports for the telecommunication companies view other telephone holding companies as the best proxies for the subject telephone holding company.

3) DR. VANDER WEIDE OVERSTATES THE RISKS INHERENT IN THE BUSINESS OF LEASING UNBUNDLED NETWORK ELEMENTS AT WHOLESALE PRICES.

Q. HOW DO YOU RESPOND TO DR. VANDER WEIDE'S ATTEMPT TO JUSTIFY HIS APPROACH ON THE GROUNDS THAT INVESTMENT IN LEC FACILITIES (SUCH AS VZ-VA) THAT ARE REQUIRED TO PROVIDE UNES INVOLVES RISKS AT LEAST AS GREAT AS INVESTMENT IN THE AVERAGE S&P INDUSTRIAL COMPANY?

A. With extreme skepticism. Dr. Vander Weide merely assumes (without offering a shred of empirical support) that the risks faced by VZ-VA are the same as the average industrial company. In fact, because the risks attendant to the business of wholesaling unbundled network elements to CLECs are not as great as those faced by the average industrial, Dr. Vander Weide's DCF analysis of the S&P Industrials yields an unduly generous equity return.

Q. IN WHAT WAY HAS DR. VANDER WEIDE EXAGGERATED THE RISKS INHERENT IN THE BUSINESS OF SELLING UNBUNDLED NETWORK ELEMENTS AT WHOLESALE?

A. In his discussion of risk, Dr. Vander Weide blurs the necessary distinction between various services provided by local exchange companies. Dr. Vander Weide devotes most of his discussion to the risks involved in the business of providing local exchange service at retail rather than the business of providing unbundled network elements at wholesale. In estimating the cost of capital for the business of providing unbundled network elements at wholesale, only the risk encountered in that wholesale line of business is relevant. VZ-VA's other lines of business – be they local exchange service, intraLATA toll service, cellular phone service etc. – are completely irrelevant.

Moreover, in describing the local exchange market Dr. Vander Weide presents a distorted view of VZ-VA's ability to compete. Dr. Vander Weide suggests that the level of competition in Virginia is thriving and expanding rapidly (VW p. 37), but overlooks the fact that VZ-VA is the highly dominant and most experienced competitor in the local Virginia market.

Q. CAN YOU PLEASE PROVIDE AN EXAMPLE OF DR. VANDER WEIDE'S CONFUSION OF THE BUSINESSES OF LOCAL EXCHANGE SERVICE AND LEASING UNBUNDLED NETWORK ELEMENTS?

A. Yes. For this testimony, Dr. Vander Weide relies on the testimony of Harold West III. Mr. West goes on at some length about the competition allegedly faced by VZ-VA in providing local exchange service but fails to narrow his focus solely to facilities-based competition.

Local competition that is not facilities-based is irrelevant to the question of the risk faced by a firm in business solely to provide access to local exchange facilities to itself and to third parties. If anything, the increased competition at the retail level would translate into increased opportunities in the wholesale business of leasing network elements, thus making the wholesale business less risky.

Q. HAS VERIZON IN THE PAST RECOGNIZED THE DISTINCTION BETWEEN COMPETITION AT THE RETAIL LEVEL AND COMPETITION AT THE WHOLESALE LEVEL?

A. Yes. For example, in its 4th Quarter 1999 Investor Quarterly, Verizon (then Bell Atlantic) asserted:

> And on the wholesale side, our high-efficiency network model allows us to retain as much traffic on our network as possible. Remember, *virtually all the competition in the local consumer marketplace travels over our network today*, which allows us to retain a high percentage of our retail revenues. The net of all this is a very healthy business: volumes are strong and growing, our wholesale business will grow this year at close to double digit rates, and *even lost market share translates into more traffic for our network*. [emphasis added].

Q. CAN YOU PLEASE PROVIDE EXAMPLES OF DR. VANDER WEIDE'S DISTORTION OF THE LOCAL EXCHANGE MARKET?

A. Yes. In his testimony, Dr. Vander Weide argues that VZ-VA will have significant disadvantages when faced with competition from CLECs. [Vander Weide Direct Testimony ("VW") pg. 38] He claims that AT&T has a significant competitive advantage compared to Verizon VA because AT&T can bundle its services. [VW pg. 39] Apparently, Dr. Vander Weide believes that customers are more likely to shift their local exchange service to AT&T than to change their long distance carrier. He overlooks, however, the possibility that VZ-VA could keep and attract customers by virtue of being the known and established local exchange provider, or simply by offering a better deal. Verizon itself has presented a much more optimistic view. In its 4th Quarter 1999 Investor Quarterly, it stated:

> On the retail side, we will benefit from the new brand we'll be introducing this year, the bundling opportunities as regulatory barriers fall, and the heightened competitiveness of our core telecom products with LD entry. (*Actually, we have more to gain from being able to compete better for business customers than we have to lose in the local consumer market.*) [emphasis added]
>
> More recently, Verizon President and Co-CEO Ivan Seidenberg noted in Verizon's second quarter 2001 press release that "[i]n the second quarter, our long-distance business knocked the cover off the ball not only in Massachusetts but across our footprint ..."[4]

Q. ARE THERE DIFFERING VIEWPOINTS ON THE ABILITY TO CLEC'S TO COMPETE?

A. Yes. For example, Brian Adamik of the Yankee Group comments that:

> As serious as California's electric power crisis is, it's a minor inconvenience compared to the looming disaster in the national telecommunications market created in the wake of the Telecom Act of 1996.
>
> In telecommunications, we are rolling back the competitive progress made over the last ten years --- disabling the enabling industry of economic growth just when we need it most.
>
> There is still no meaningful competition in residential local service. Worse, long distance and other famously competitive segments of the telecom market are moving towards monopoly control. As incredible as it seems, we are well on our way to re-creating regional versions of the old Bell System monopoly, controlled by the four giant regional Bell companies --- SBC, Verizon, Bell South and Qwest/U.S. West.
>
> Those companies are gradually winning permission to enter long distance in individual states with their local service monopolies still intact. In those states, the regional Bell company becomes the only effective provider of

[4] Verizon Press Release, "Verizon Communications Second Quarter Earnings Highlighted by Strong Long-Distance and Wireless Sales," July 31, 2001

> combined local and long-distance service. For a company in that position, grabbing long-distance market share is like shooting fish in a barrel.
>
> The Big Three long distance companies (AT&T, WorldCom/MCI and Sprint) were expected to become strong competitors in the new market for combined local and long distance. Yet the Bells have used their control of the local networks to keep long-distance carriers and other potential competitors out of the local market. Meanwhile, the Big Three are struggling for their future existence.
>
> Their stock went into free fall over the last year. AT&T is restructuring itself into four independent businesses to reduce its dependence on voice long distance. WorldCom/MCI, a pioneer in long- distance competition, is now a takeover target by SBC, the biggest of the regional Bells. Speculation persists that Bell South wants to acquire Sprint at its current bargain price. Of the hundreds of smaller companies now competing in long distance, it's clear that only a handful will survive.
>
> Many new companies launched to compete in local services are in financial collapse as they try to compete with the Bells while still depending on them for local network support. Furthermore, at least eight high-speed Internet access providers went out of business or declared bankruptcy in late 2000 and early this year.[5]

Q. WHAT EVIDENCE DO YOU HAVE THAT INCREASED COMPETITION AT THE RETAIL LEVEL WOULD MAKE THE WHOLESALE BUSINESS OF LEASING UNBUNDLED NETWORK ELEMENTS LESS RISKY?

A. Verizon's own management has expressed this view. As I noted in my direct testimony, Verizon (then Bell Atlantic) stated in its mid-year 1999 Investor's Reference Guide that the business of providing network elements "provides a unique opportunity to add new

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[5] Brian Adamik, Yankee Group, "The death of competitive telecom?", CBS MarketWatch.com, Inc., May 3, 2001.

revenues onto our platform without significant incremental capital investment …" Verizon also noted that "our networks must be able to handle increased traffic volumes from competitors utilizing our infrastructure as we move into a wholesale environment." Verizon's statements to the public indicate that its own management believes that the network element wholesale business is subject to much less risk than its retail local exchange business.

Q. DOES DR. VANDER WEIDE DISAGREE WITH YOUR ASSERTION THAT THE MARKET HAS ALREADY ACCOUNTED FOR THE RISK OF POTENTIAL COMPETITION?

A. It does not appear so (although we do disagree as to the extent of competition that the market actually expects). On page 35 of his direct testimony, he stated that "[i]nvestors are primarily interested in expected future competition when they assess the current investment risk of Verizon VA because expected future competition is a primary determinant of volatility in the expected returns on their investment."

Q. IF DR. VANDER WEIDE IS CORRECT THAT THE MARKET HAS INCORPORATED THIS INFORMATION ALREADY, IS THERE ANY NEED TO HYPOTHETICALLY ASSUME A FULLY COMPETITIVE MARKET AND THEREBY USE S&P INDUSTRIALS AS COMPARABLE COMPANIES INSTEAD OF TELEPHONE HOLDING COMPANIES?

A. None whatsoever. The DCF method for estimating the cost of equity is based on market prices which incorporate all available information in the marketplace.

Q. ARE YOU SAYING THAT THE PROSPECT OF INCREASED COMPETITION IN THE RETAIL PHONE SERVICE MARKET IS IRRELEVANT FOR PURPOSES OF DETERMINING A TELRIC RATE OF RETURN IN THIS PROCEEDING?

A. Yes. The FCC, in its August 8, 1996 Order, explicitly defined the relevant risk as the risk incurred in the business of leasing unbundled network elements at wholesale. [¶702] (That the FCC has indicated that "the risk adjusted cost of capital need not be uniform for all elements," further indicates that the relevant risks are those inherent in the business of leasing elements itself, not the risks entailed with retail phone service. [¶702.]) As I said in my prepared direct testimony, whether competition in the local exchange service business will increase depends in the first instance on the unbundled element price to be charged to the new entrants by the incumbent LECs, which is determined by (among other things) the cost of capital. Setting the cost of capital too high due to expectations regarding intense competition down the road (based on Dr. Vander Weide's incorrect interpretation of the FCC's August 8, 1996 Order) could foreclose that competition from ever arising by increasing the price of network elements above forward looking levels. Conversely, setting the cost of capital too low (on the assumption that little or no competition will develop) would attract unexpectedly high levels of competitive entry by decreasing the price of unbundled network elements below forward looking levels. If one instead focuses on the risks attendant to the business of selling access to retailers at wholesale cost, one can derive a cost of capital that is not biased by unsubstantiated speculation about downstream effects in the retail market.

Q. HOW MUCH UNE ACCESS LINE COMPETITION HAS DR. VANDER WEIDE CITED AS EVIDENCE IN HIS TESTIMONY?

A. Very little. Dr. Vander Weide refers to Mr. West's testimony, which itself is ambiguous on the number of lines provided by CLECs on a facilities basis. At page 4 of his testimony Mr. West states that "[b]y the end of May 2001, CLECs had more than 121,000 facilities-based *and UNE-Platform* residential directory listing and approximately 29,000 facilities-based business directory listings." (*emphasis added*). At page 5 of his testimony, however, Mr. West states that "as of the end of May, CLECs had obtained approximately 150,000 facilities-based directory listings, including more than 121,000 for residential customers and more than 29,000 for business customers…". Lines provided as UNE-Platform are not facilities-based competition.

According to the FCC's May 2001 report on local competition, Virginia had 4,732,058 lines, of which only 414,432 lines were served by CLECs as of December 31, 2000. Thus, only approximately 8.8% of the state lines were served by competitors.[6] This percentage overestimates the possible level of facilities-based competition, however, because it includes non-facilities based lines, such as UNE-P and resale lines which Verizon retains as its wholesale UNE customers. Giving Mr. West the benefit of the

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6 FCC News, *Federal Communications Commission Releases Latest Data on Local Telephone Competition*, May 21, 2001, Table 6.